Investors are taking a shine to last year's corporate debt pariahs: BAML

Investors are taking interest in the worst-rated rung of the investment-grade corporate bond market, reflecting how much the recent selloff in corporate paper has cheapened valuations.

According to a Tuesday note from Bank of America Merrill Lynch, a survey found fixed-income investors capable of buying across the corporate bond universe are forecasting the strongest performance for bonds rated BBB versus bonds with other credit ratings. The chart below shows 38% of investors expect BBB-rated debt to outperform the rest of the market for the next 12 months, up from 20% back in November.

That represents an about-face from several months ago when investors said fears about excesses in corporate debt were exemplified by the ballooning issuance of BBB-rated debt, which exceeds half of the more than $6 trillion-sized investment-grade bond market.

The chief concern is that when the next downturn in the economic cycle arrives, credit ratings firms will downgrade many of these BBB-graded issuers into noninvestment grade, or "junk" status. More conservative market participants who can only hold investment-grade bonds would have to sell the bonds of such "fallen angels", resulting in vicious spiral of further price declines.

Yet the survey results don't indicate investors are taking a rosier view of U.S. corporate balance sheets.

In fact, the dour sentiment over U.S. corporate debt markets has lingered as recession fears gain ground. But market participants say the aversion to corporate credit in the past few months had overextended itself, widening yield premiums for BBB-rated bonds to more appetizing levels.

A similar logic had underpinned the recent rush into high-yield bonds as investors expect increased buying to push yields lower, narrowing the spread versus Treasurys. Debt prices move in the opposite direction of yields.

See: Where Gundlach sees risks, some on Wall Street size up junk bonds as 'opportunity'

"With more attractive valuations and expected buying, not surprisingly U.S. credit investors have turned bullish on credit spreads for the next three months, more neutral for a six-month horizon whereas they remain bearish for the longer term," wrote analysts at Bank of America Merrill Lynch.

The yield spread for BBB-rated corporate bonds versus Treasurys, or the credit spread, widened to 2.05 percentage points on Jan. 4, its largest gap since July 2016. Since then, the spread has narrowed slightly to 1.88 percentage points, according to an index of investment-grade bonds provided by ICE Data Services.

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